United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-1581

No. 74-1581

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

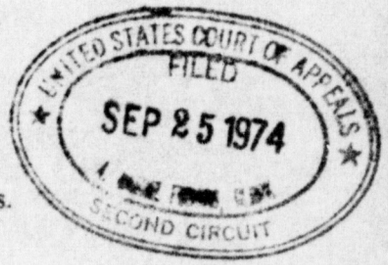
ROBERT R. FELTON et ano.,

Plaintiffs-Appellants,

-against-

WALSTON AND CO., INC., et al.,

Defendants-Appellees.



On Appeal from the United States
District Court for the Southern
District of New York

**BRIEF OF DEFENDANT-APPELLEE
MAIN LAFRENTZ & CO.**

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Dated: September 25, 1974

TABLE OF CONTENTS

BRIEF OF DEFENDANT-APPELLEE
MAIN LAFRENTZ & CO.

TABLE OF AUTHORITIES

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BRIEF OF DEFENDANT-APPELLEE MAIN LAFRENTZ & CO.

This brief is submitted on behalf of defendant-appellee Main Lafrentz & Co. ("Main Lafrentz"). We rely upon the brief of defendants-appellees Marine Midland Bank-New York ("Marine Midland") and Joel Brownstein, which deals with the major issues of law and fact relevant to this appeal; this brief will concentrate upon the issues on this appeal as they apply to Main Lafrentz, an international firm of certified public accountants.

This appeal challenges the dismissal by the United States District Court for the Southern District of New York, Hon. Dudley B. Bonsal, of the last of a series of complaints filed by plaintiff Felton, pro se and as attorney for a purported class (and later on behalf of plaintiff Egan, another attorney, as well) for failure to plead fraud with particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure. The amended complaint dismissed by Judge Bonsal was the fifth actual or proposed complaint filed in this action -- which, like each of the previous proposed or actual complaints, was replete with reckless and unsubstantiated charges, general in form and often incomprehensible. In a nutshell, after giving appellants more than ample opportunity to meet their obligations under the Rules, Judge Bonsal dismissed their complaint without further leave to amend, and thus relieved the Court, and Main Lafrentz, of any further burden from this frivolous litigation.

Because of the studied obscurity of the appellants' brief, and its elliptical references to Main Lafrentz's summary judgment motion, which was not reached by the Court below, we will begin with a discussion of what this case is about, and an explanation of the Main Lafrentz summary judgment motion.

STATEMENT OF THE CASE

Plaintiff-Appellant Felton

This securities action was commenced as a purported class action by plaintiff-appellant, Robert Felton, an attorney-at-law, 95 percent of whose practice is in the negligence field (Tr. 15).* He intended to act both as plaintiff and as attorney for the class, and he stated at his deposition that he expected to apply for an attorney's fee in connection with any disposition of the class action (Tr. 313-15).

According to Felton, he made his first purchase of the stock of 3I Co./Information Interscience Incorporated ("3I") in July of 1970. The purchase came about after Felton was told by his brother that there was a certain Mr. Nissan, a registered representative with Walston & Co., Inc. ("Walston"), who was "bright" (Tr. 54). At his deposition Felton claimed that he phoned Nissan and was told by Nissan that he (Nissan) would take Felton on as a customer if he would sell all of his other stock (Tr. 55). Without more, Felton did so and became a customer of Nissan (Tr. 56).

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* Photocopies of the transcript of Felton's deposition have been submitted to the Court. References to the transcript will be cited herein as "Tr. ___".

One of the stocks allegedly recommended to Felton by Nissan was the 3I stock involved in this action. According to Felton's testimony, he first purchased the 3I stock based on Nissan's rosy predictions that the stock would greatly appreciate in value and he would thus be able to recoup his loss in another stock (Tr. 86).

At the time Felton made his first purchase of 3I stock, he knew absolutely nothing about the company. He did not even know what business 3I was in (Tr. 86), nor did he see a financial statement or report of the company. Nevertheless, Felton purchased 2,000 shares of 3I stock at $4.25 per share on July 9, 1970. (Tr. 386)

It is not necessary to detail the history of Felton's purchases and sales of 3I stock reflected in his deposition testimony. Suffice it to say that the stock greatly appreciated in value, and that over the course of several months Felton sold portions of his stock at various times and at enormous profit. According to Felton's own testimony, the impetus for all his purchases was the statements by his stockbroker, Nissan, that the price of the stock would continue to increase. Thus, in the short period between July 9, 1970 and June of 1971, Felton was in and out of the 3I stock at various

times, each time making a handsome profit, with the range of the stock going from 4-1/4 a share when he first purchased it to 19-3/8 when he made his last sale (232a).

Unfortunately for Felton, the precipitous rise in the value of the 3I stock, which had paid enormous profits to him, was matched by a precipitous decline after he made his last purchase at approximately $20 per share (232a). Having seen his enormous profits turn to loss, Felton sought by this action to recoup the losses on this speculation in 3I by initiating a class action and obtaining an attorney's fee in connection with its disposition.

Felton's Charges Against Walston and Marine Midland

The original action, commenced on May 17, 1973, did not name Main Lafrentz as a party (9-17a). That complaint was based on an alleged claim of manipulation by 3I, Walston and Marine Midland. It would serve no purpose to analyze that complaint here in detail, especially since Judge Bonsal dismissed it (with leave to replead) for failure to plead fraud with particularity (2a). What is significant is that these manipulation claims had nothing whatever to do with Main Lafrentz. The claim against Main Lafrentz, which was first asserted in the first amended complaint filed on

August 14, 1973 (35a-71a), related solely to two transactions reflected in the financial statements contained in 3I's 1970 Annual Report on which Main Lafrentz had issued a qualified opinion.

The claim against Main Lafrentz was obviously an afterthought. This is evidenced not only by the fact that the claim was asserted belatedly and in an action which had no relation to the financial statements, but also by the fact that the financial statements had nothing to do with Felton's purchases. As noted above, Felton's original purchases were made without looking at any financial statements. Felton contends that he received a copy of 3I's Annual Report from his stockbroker shortly after it was issued (about March of 1971, which was about eight months after Felton's initial purchase), but that he had read it only hastily, did not recall whether he had read the notes to the financial statement and that he did not retain a copy of it (Tr. 354-57).

3I Company

3I was a commercial storehouse of scientific and technical information, which included various data bases in biomedical, technical and scientific fields. It was also engaged in performing editing and indexing services

in connection with technical material, and in microfilming services as well as other technical data gathering and dispensing services. Despite consistently poor results, including losses of $692,460 (46¢ per share) in 1969 and $555,577 (34¢ per share) in 1970, both contained in the 1970 Annual Report at issue here, the price of the 3I stock consistently sky-rocketed (235a). These financial results, compared to the movement in the price of the stock, probably explain why the financial statements had so little to do with Felton's purchases.

Acquisition of the Data Bank License from Excerpta Medica

The indisputable facts, contained in documents submitted in connection with Main Lafrentz's summary judgment, show the following with respect to 3I's acquisition of a certain data bank license which was one transaction which forms the basis of the claim against Main Lafrentz:

On September 19, 1969 3I entered into an agreement with Stichting Excerpta Medica ("Excerpta Medica"), a non-profit foundation located in the Netherlands, by which 3I obtained an exclusive license to use its data bank in in the United States (Ex. 1).* In accordance with the

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* A copy of this agreement was attached to the original Main Lafrentz summary judgment motion as Exhibit 1 and has been included in a separate binder of Exhibits transmitted to the Court on this appeal. References to that binder will be cited herein as "Ex. ___."

contract, 46,666 shares of 3I stock were issued to Excerpta Medica. This was restricted stock, but Excerpta Medica had the right to require 3I to purchase this stock from Excerpta Medica in October 1971 at $15 per share and to require 3I to register those shares not repurchased. These shares were valued at $700,000 on the books of 3I on the basis of the $15 price, which was below the market value at the time and was the price at which 3I was obligated to pay Excerpta Medica in cash at a date certain.

Simultaneously, 3I by letter agreement dated September 19, 1969, obligated itself to pay a finder's fee in the sum of $300,000 to Fred Von Eugen, $150,000 of which was paid then, and the other $150,000 of which was to be paid within 180 days of the closing (Ex. 2). By agreement dated June 15, 1970, the obligation to pay Von Eugen the second $150,000 was susperseded by the obligation to issue him 30,000 shares of 3I stock on December 1, 1970, along with 3I's agreement to repurchase those 30,000 shares in July of 1971 at a price of $5 per share, and Von Eugen's right to require 3I to register the 30,000 shares (Ex. 3). Taking into account the facts that 3I was obligated to repurchase at $5 per share and that this price was below the then market value, the 30,000 shares to be received by the finder was valued on

the books of 3I at $150,000.*

Disclosure of the Data Bank License Acquisition on the 3I Balance Sheet

Taking into account the agreements of the parties, as amended as of that date, on June 30, 1970, the date of the balance sheet in 3I's 1970 Annual Report, 3I reported that it had paid a total of $1,000,000 for the acquisition of this data bank license as follows (Ex. 5):

Cash	$150,000
46,666 shares issued in 1969 (valued at the repurchase price of $15 per share)	700,000
30,000 shares to be issued in 1970 (valued at the repurchase price of $5 per share)	150,000**

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* Pursuant to a later amendment, dated April 5, 1972, Von Eugen agreed to relinquish his right to require 3I to register his stock and to repurchase his stock at $5 per share in exchange for the issuance to him of an additional 7,500 shares (Ex. 4). As a result, as of April 5, 1972, Von Eugen had received a total of 37,500 shares in connection with 3I's purchase of this data bank license. Parenthetically, Main Lafrentz was not the auditor for 3I at that time. It was succeeded by Lybrand, Ross Bros. & Montgomery ("Lybrand") after completing the fiscal 1970 audit at issue here.

** Needless to say, the additional 7,500 shares issued to the finder in accordance with the amendment dated April 5, 1972 (Ex. 4) did not appear in 3I's financial statements until the end of the 1972 fiscal year.

The annual report for the fiscal year ended June 30, 1970 (Ex. 5) showed the following with respect to data bank licenses:

Data bank licenses, at cost (note 1) $1,028,606

Of this total $1 million was attributable to the data bank license acquired from Excerpta Medica.*

Note 1 to the 3I financial statements of June 30, 1970 (Ex. 5) set forth in detail the manner in which 3I had valued the data bank license acquired from Excerpta Medica. It stated that the total consideration was $1,000,000, and that that sum included 46,666 shares, which 3I could be required to purchase at $15 per share, and 30,000 shares which 3I could be required to repurchase at $5 per share. And Note 6 to the same financial statement (Ex. 5) showed the following with respect to the stock issued in connection with the Excerpta Medica transaction:

	Common Stock Class A	Common Stock Class B	Capital in excess of par value	Accumulated deficit
Stock issued in connection with agreement with Excerpta Medica Foundation (note 1)	$7,667		$842,333	

* The additional $28,606 was attributable to two other data bank licenses.

The dollar amounts attributable to the stock issued in this transaction, as set forth in Note 6, totals $850,000. Any shareholder or prospective investor could have made the arithmetic computations which showed that the 3I stock which 3I was obligated to repurchase for $15 per share had been valued at $700,000 (46,666 x $15), and that the stock which 3I was obligated to repurchase for $5 per share had been valued at $150,000 (30,000 x $5), totaling the $850,000 set forth in Note 6, and that the remainder, $150,000 had been paid in cash ($1,000,000 less $850,000). It should also be noted that in addition to this full disclosure concerning the data bank license and the way it was being carried on the 3I books, the Main Lafrentz opinion was qualified with respect to the data bank license, i.e., the opinion stated that the financial statements "presented fairly" the financial position of 3I "subject to the realization of carrying value of data bank licenses and investments in affiliated companies as discussed in notes 1 and 2 ...."

Felton's Claim in the First Amended Complaint against Main Lafrentz Regarding the Data Bank License and the Summary Judgment Motion with Respect Thereto

To the extent that one can understand the first amended complaint's obscure and verbose allegations, it appears to make various charges about the disclosure

concerning the data bank license in the 3I financial statements. The basis of the Main Lafrentz summary judgment motion was that there had been full disclosure and a qualified opinion on this item, and that each of the contentions in the first amended complaint was totally devoid of merit and based on a complete misconception of the facts.

The first amended complaint alleged that the data bank license was overvalued in that 3I had paid only $150,000 plus 7,500 shares for this license (53a, ¶¶ 129, 130). However, as Main Lafrentz pointed out in its summary judgment motion, Felton had overlooded the issuance of 46,666 shares to Excerpta Medica and 30,000 shares to the finder, Von Eugen, in connection with this transaction, and the disclosure in the notes which disclosed how these shares had been valued:

(a) The first amended complaint appeared to contend that Excerpta Medica never actually received the 46,666 shares of 3I stock and that it had received only a "right" to require the "repurchase" of 3I stock at $15 per share (52a, ¶ 120). But, there can be no doubt but that Excerpta Medica received the 46,666 shares of stock in 1969: Exhibit 6 to Main Lafrentz's summary judgment motion was a photocopy of the receipt for those shares dated

October 30, 1969.*

(b) In the first amended complaint, Felton alleged that the 46,666 shares held by Excerpta Medica were merely "stock rights" and were so characterized in 3I's 1972 financial statement (52a, ¶ 121). This, however, was a complete misreading of that financial statement (Ex. 7). As noted above, Excerpta Medica actually had received the 46,666 shares in 1969 (Ex. 6). In addition, a reading of the note to the 1972 financial statements referred to in Felton's first amended complaint shows that the "right" referred to was a right which Excerpta Medica had in addition to the 46,666 shares it had received -- the right to require 3I to repurchase those shares. It was this "right" which terminated in 1972. But the 46,666 shares issued to Excerpta Medica in 1969 and reflected in the receipt (Ex. 6) remained as valid, outstanding shares.

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* Of course, the entire allegation was irrelevant because whether or not Excerpta Medica actually received the stock was of no consequence. Under the agreement by which the data bank license was granted (Ex. 1), there was a specific obligation on the part of 3I to deliver stock (as well as to repurchase it at $15 per share on a stated date) and that obligation was sufficient to establish the valuation.

(c) As explained above, Von Eugen received $150,000 at the closing and a promise by 3I to pay an additional $150,000 within 180 days of the closing (Ex. 2). By an agreement dated June 15, 1970, Von Eugen received 30,000 shares, which 3I was required to repurchase at $5 per share in exchange for the promise to pay the second $150,000 (Ex. 3). The first amended complaint charged that the $150,000 debt to Von Eugen was not reflected on the 3I balance sheet (52-53a, ¶ 124). However, the June 15, 1970 agreement with Von Eugen had already satisfied the obligation to pay Von Eugen the additional $150,000, and that agreement stated specifically that that $150,000 "is not due and payable to you." (Ex. 3) Thus, it would have been entirely improper to have reflected that the second $150,000 was still due on the 3I balance sheet as of June 30, 1970.*

(d) Felton alleged in his first amended complaint that Von Eugen had only received $150,000 (which concededly he did receive) and 7,500 shares of the 3I stock. The

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* Felton, after much hemming and hawing, finally had to admit this ineluctable truth at his deposition (Tr. 464). At his deposition he came up with the unique explanation that the first amended complaint was not referring to the balance sheet as of June 30, 1970 when it referred to the "balance sheet" in paragraph 125, but to the "running balance sheet" in 3I's books -- whatever that may be (Tr. 465-67).

summary judgment motion pointed out that the allegation was based upon a misreading of the 1972 financial statements on file with the SEC. The first amended complaint charged that Von Eugen was never paid the $150,000 balance (53a, ¶ 125), but, as noted above, the agreement to issue him 30,000 shares replaced that obligation. Second, Felton claimed that these 30,000 shares were not issued to the finder and that all he received was "stock rights" for which he was given 7,500 shares in 1972 (53a, ¶¶ 127, 128). But the 1972 financial statements, audited by Lybrand (Ex. 7, note 7) show that Von Eugen received 7,500 shares in 1972 in addition to the 30,000 shares he had received in 1970. The additional 7,500 shares were issued in exchange for his waiver of the right to have the 30,000 shares issued to him in 1970 repurchased or registered.

Thus, the Main Lafrentz summary judgment motion pointed out, 3I did not exchange only $150,000 cash plus 7,500 shares for the data bank license, as alleged in the first amended complaint (53a, ¶¶ 129, 130). The amount paid by 3I as of June 30, 1970 was exactly as reflected in its 1970 financial statements: $150,000 in cash, 46,666 shares of 3I stock, which it was required to purchase at $15 per share, and 30,000 shares of 3I stock, which it was required to repurchase at $5 per share.*

*That 30,000 shares was to be issued in December, 1970. The 1970 financial statements (Ex. 5) disclosed that these shares were to be issued then, but were reflected as if outstanding on the balance sheet date.

(e) Finally, the first amended complaint alleged that the data bank license was "worthless as to defendant 3I Co. and in fiscal 1972, defendant 3I Co. wrote off the $1,000,000 'cost" at a complete loss" (54a, ¶ 139). Of course, the claim against Main Lafrentz could only relate to its (qualified) opinion rendered with respect to the 1970 financial statements. Felton stated at his deposition that he was claiming that this license was worthless in 1972 (when it was written off) (Tr. 488), and, perhaps as early as 1971 (Tr. 515-16). Consequently, Felton all but admitted that his claim that the license was worthless did not intend to allege that it was worthless in 1970, the date of the Main Lafrentz qualified opinion.

Thus, the Main Lafrentz summary judgment motion pointed out, there was no merit whatever to the contention that the 3I financial statements misstated anything with regard to the consideration for the acquisition of the data bank license. The acquisition cost of $1 million was stated on the books of 3I at that figure, and the specific method of valuation were also set forth. In addition, the Main Lafrentz opinion specifically called attention to the fact that the figure on the 3I balance sheet was subject to the qualification shown in the Main Lafrentz opinion, and subject to the notes, which clearly indicated that this $1 million figure might never be realized by the company.

In addition, it is significant that Lybrand, which is not a defendant in this action, succeeded Main Lafrentz as the auditors for 3I after the issuance of the financial statements for the 1970 fiscal year. An examination of the financial statement for 1971, and the opinion of Lybrand, shows that the data bank license acquired from Excerpta Medica was still valued on the 3I books at $1 million in that fiscal year (Ex. 8). And, like Main Lafrentz, Lybrand qualified its opinion with respect to the value of the data bank license. Therefore, the position of Main Lafrentz that the company had adequately disclosed the facts with respect to this data bank license and that it was necessary to qualify the opinion with respect to its value was corroborated by similar independent action taken by Lybrand, its successor accountants.*

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* Significantly, the 1972 financial statements (Ex. 7), again issued during the period that Lybrand was the auditor for 3I, shows that the $1 million cost of this data bank license was charged to operations in that year as an extraordinary item because, "This amount was deemed not to be recoverable through future operations because of the losses sustained and the annual fee obligations under the present agreement." (Ex. 7, Note 5) The Main Lafrentz qualification was that the $1 million valuation of the data bank license on the 1970 financial statement (Ex.5) was "subject to the realization of carrying value of data bank licenses", i.e., subject to the ability of 3I to realize the $1 million value by amortizing it against profits from its operation. Thus, two years after the Main Lafrentz qualified opinion was issued, 3I, having been unsuccessful in marketing these services profitably, determined that the $1,000,000 cost would not be realized, or recovered, and wrote off the asset.

Acquisition of Scientific Literature Corp.

The second charge against Main Lafrentz in the first amended complaint, upon which the second prong of the Main Lafrentz summary judgment motion was based, related to 3I's acquisition of a wholly-owned subsidiary, Scientific Literature Corp. ("SLC") pursuant to an agreement dated April 25, 1969 between 3I and the defendants S. Kim Kessler and Geraldine Kessler ("the Kesslers"), the major shareholders of SLC (Ex. 9). In accordance with the provisions of that agreement, the Kesslers were entitled to a payout consisting of as many as 44,800 additional shares of 3I stock, depending upon the "pre-tax earnings" of SLC during the 1970 and 1971 fiscal years.

"Pre-tax earnings", as defined in the acquisition agreement, excluded "allocation of general administrative cost and expenses of 3i except as shall be directly attributable to the operation of Subsidiary's business as a wholly-owned subsidiary of 3i." (Ex. 9, ¶ 15(b)(ii)). During the 1970 fiscal year SLC's results of operations reflected a profit of $81,307 before taxes and allocation of indirect expenses (256a). However, there was a charge from 3I to SLC of $82,362 for indirect general and administrative expenses for that fiscal year (256-57a; Ex. 10), which charge was not counted in determining the Kesslers' right to obtain additional 3I shares (Ex. 9).

The acquisition agreement (Ex. 9) contained restrictions on the operation of SLC; in order to remove some of them 3I amended its agreement with the Kesslers on November 2, 1970 (Ex. 11). By that time, on the basis of the "pre-tax earnings" (as defined in the agreement) (Ex. 9) of $81,307 during fiscal 1970, and the results of operations in the first quarter of the 1971 fiscal year, 3I apparently forecast that SLC would earn sufficient amounts to entitle the Kesslers to the maximum payout. Under the amended agreement (Ex. 11) the Kesslers released 3I from certain restrictions regarding the operations of SLC, and 3I issued to the Kesslers the 44,800 shares of 3I stock provided under the acquisition agreement.

Disclosures in the 3I Financial Statements Concerning SLC

Since the financial statements which appeared in the 1970 Annual Report contained only a consolidated balance sheet and a consolidated statement of operations, there was no separate statement for any of the 3I subsidiaries, including SLC. However, because the acquisition agreement between 3I and the Kesslers (Ex. 9) had been amended before the date of the opinion (Ex. 11), note 1 to the 3I consolidated financial statements (Ex. 5) outlined the amended terms of the acquisition agreement.

Allegations Against Main Lafrentz
Concerning SLC and the Summary
Judgment Motion Addressed Thereto

The only allegations made against Main Lafrentz regarding SLC in the first amended complaint was that SLC had sustained a net loss for the year ended June 30, 1970 (56a, ¶ 148) and that this fact had been omitted from the 3I financial statements for the 1970 fiscal year (56a, ¶ 150).

First, it must be noted that in truth SLC had a pre-tax profit of $81,307 before allocation of indirect general and administrative expenses of 3I (256-57a; Ex. 10). This was the figure used to determine the profitability of SLC in the agreement between 3I and the Kesslers (Ex. 9). The only loss in SLC for the period came by means of an allocation of indirect general and administrative expenses to 3I of $82,362 (256-57a) (a not unusual device employed to minimize state income taxes). Moreover, even after this internal calculation, SLC had a loss of only $1,055 for the 1970 fiscal year.

The Main Lafrentz summary judgment motion pointed out that even if the allocation of indirect costs were taken into account, there was no reason for 3I to state in its financial statements that there had been a loss of $1,055 by SLC during the fiscal year 1970, and there could be no liability to Main Lafrentz arising out of this item for the following reasons:

(a) Main Lafrentz had examined the results of operations of SLC and rendered an opinion solely for inclusion in the consolidated financial report of 3I and subsidiaries. Main Lafrentz had not issued a separate report concerning the financial condition of SLC. And the $1,055 loss in any event arose out of an inter-company change, which does not even appear in the consolidated figures.

(b) The miniscule loss of $1,055 by one subsidiary could not possibly be material, especially in light of the consolidated net loss of $555,577 disclosed in the 3I financial statements.

(c) Even if, contrary to the facts, SLC had suffered a loss of $1,055 as defined in the agreement with the Kesslers, it would not have precluded execution of the new agreement: The loss was minor; it could have been made up in the next fiscal year (since the payment of the additional shares was based on the average "pre-tax earnings" for the two fiscal years) (Ex. 9). Stockholders were informed in note 1 to the 1970 3I financial statements (Ex. 5) that a new agreement had been written, and that it was management's opinion that "SLC will achieve the necessary earnings which would have entitled the sellers to receive these shares under the original agreement." Every shareholder knew he was relying solely on management's opinion.

(d) The net loss of $1,055 was disclosed on Schedules III and XVII of Part I of 3I's Form 10-K for the fiscal year ended June 30, 1970 filed with the SEC (253a). This factor alone belies any claim of intent to defraud.

Additional Allegations in the First Amended Complaint

The summary judgment motion also pointed out that the first amended complaint charged Main Lafrentz with aiding and abetting other defendants in violating the securities laws. That complaint, however, did not elucidate the nature of this alleged "aiding and abetting." And at his deposition Felton refused to explain the nature of the claims in the complaint that Main Lafrentz aided and abetted others in violating the securities laws on the ground that this was his "work product" (Tr. 630-32).

Dismissal of the First Amended Complaint and Filing of the Final Amended Complaint

After the summary judgment papers were filed, Felton made two motions to further amend his complaint, which included copies of proposed second and third amended complaints (179-222a; 303-47a). The last motion proposed to add Edward J. Egan, another attorney, as a co-plaintiff

(297a).* Judge Bonsal sua sponte dismissed the first amended complaint and rejected the two proposed amended complaints for failure to comply with Rules 8 and 9(b); he allowed Felton to file a new amended complaint, his fifth attempt to formulate a complaint consistent with the Rules.** The Court also noted that Main Lafrentz could renew its summary judgment motion after this new complaint was filed.

After the last amended complaint was filed (489a), Main Lafrentz renewed its summary judgment motion, and moved, alternatively, for dismissal for failing to allege fraud with sufficient particularity as required by Rule 9(b) (503a et seq.).

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* Mr. Egan's deposition had not been completed at the time that the District Court granted the motion dismissing the final amended complaint. Therefore, we will not go into an exposition concerning how this attorney became involved in this suit. Parenthetically, it should be mentioned that in his motion to intervene, Mr. Egan nowhere mentioned the 1970 financial statements (299-300a).

** Assuming it is relevant, Felton claims that Judge Bonsal did not state that this was to be a "final" amended complaint (Br. p. 8). Defendants' counsel recall that Judge Bonsal did make such a statement. In any event, the only evidence in the Record is Judge Bonsal's statement, in the Decision, that he had granted Felton leave to file a "final" complaint (558a).

Main Lafrentz's Motion to Dismiss and/or for Summary Judgment

The final amended complaint contained only one count against Main Lafrentz set forth in paragraphs 32 through 34. The allegations were most general in nature -- for instance, that Main Lafrentz had not followed "generally accepted accounting principles," but the nature of the principles allegedly not followed was nowhere expressed. The only allegations expressed with even the barest semblance of specificity in the final amended complaint were those in subparagraphs (a) through (e) of paragraph 34.

Main Lafrentz renewed its summary judgment motion and, in the alternative, moved to dismiss for failure to comply with the requirements of Rule 9(b). The basic thrust of the motion was that the final amended complaint was vague and general on its face, but that if the allegations were the same allegations Main Lafrentz had assumed were made in the previous proposed and actual complaints, summary judgment should be granted. Thus, Main Lafrentz went through each allegation in the final amended complaint and showed how it failed to comply with Rule 9(b). Then, on the basis of previous complaints, Felton's deposition testimony and his affidavits, Main Lafrentz made an assumption concerning what the allegation was referring to and showed that in any event, summary judgment should be granted.

For example, Main Lafrentz pointed out that paragraph 34(a) of the final amended complaint charged that the 3I 1970 financial statements "failed to disclose that 3I Co. had materially understated its current liabilities by $150,000" (500a). There was no specific allegation concerning what this alleged understatement consisted of, and, therefore, the subparagraph did not meet the pleading requirements of Rule 9(b). However, from the previous complaints, as well as the affidavit in opposition to Main Lafrentz' motion for summary judgment, it appeared that the claim was that the 3I financial statement of June 30, 1970 had failed to carry a supposed obligation of 3I to pay $150,000 to Von Eugen, the finder in connection with 3I's acquisition of a data bank license from Excerpta Medica. However, the final amended complaint overlooked the fact that the obligation to pay that $150,000 to Von Eugen, contained in a letter agreement dated September 19, 1969 (Ex. 2), had been superseded by an obligation to issue 30,000 shares to him on December 1, 1970 contained in an amended agreement dated June 15, 1970 (Ex. 3). Thus, the obligation to pay the additional $150,000 to Von Eugen no longer existed on June 30, and was not, and could not have been, shown as a current obligation on that date. (See pages 14 to 15, supra.)

Paragraph 34(b) of the final amended complaint charged that the 1970 financial statement "failed to disclose that 3I Co. materially overstated the issuance of common stock, Class A and capital in excess of par value by $150,000 (500a). Again, the final amended complaint failed to comply with Rule 9(b) in that it did not explain the manner in which it was claimed that there was an alleged overstatement. However, relying again upon the previous complaints and the affidavits in opposition to Main Lafrentz' summary judgment motion, it was assumed that the claim was that note 6 to the 1970 financial statements (Ex. 5) had overstated by $150,000 the stock issued in connection with the acquisition of the data bank license. This allegation was also based on the failure to recognize that the obligation to Von Eugen to pay him an additional $150,000 in cash had been superseded on June 15, 1970 by the obligation to issue him 30,000 shares of stock on December 1 (Ex. 3).

The obligation to issue these 30,000 shares on December 1, 1970 was fully accounted for by reflecting those shares as if they were outstanding on June 30, 1970. The balance sheet dated June 30, 1970 (Ex. 5), stated in note 1 that:

> "The shares to be issued on December 1, 1970 [to Von Eugen] have been reflected as outstanding in the accompanying financial statements."

Thus, the note clearly stated that the stock had not yet been issued, so that there could not have been an over-statement in the issuance of common stock by $150,000 as apparently alleged in paragraph 34(b). However, note 1 further stated that the shares to be issued on December 1, 1970 had been reflected in the financial statements as if outstanding, thus covering the liability to Von Eugen (as amended) in full. In sum, it was fully disclosed that (1) the "Stock issued in connection with the agreement with Excerpta Medica Foundation (note 1)" in note 6 included the 30,000 shares to be issued on December 1, 1970; and (2) those shares had not yet been issued, but were being reflected as outstanding in the financial statements on the balance sheet date.*

Paragraph 34(c) of the final amended complaint alleged that the 1970 financial statements "misrepresented the terms of the Excerpta Medica data bank license agreement and failed to disclose Von Eugen's role as a business broker." (500-501a) Main Lafrentz' motion pointed out that the manner

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* If the allegation in Paragraph 34(b) was based on the notion that Von Eugen had only received "stock rights" or the like, this was based on a misreading of the 1972 financial statements (Ex. 7); in any event Exhibit 4 to the Main Lafrentz summary judgment motion showed that Von Eugen had received those 30,000 shares and that he was issued an additional 7,500 shares in 1972 in exchange for relinquishing his right to require 3I to repurchase or register the shares. See pages 14 to 15, supra.

in which the terms of the Excerpta Medica data bank license were allegedly "misrepresented" was nowhere set forth; therefore, this allegation woefully failed to comply with the requirement that fraud be alleged with specificity.

It may be that paragraph 34(c) of the final amended complaint sought to allege that the financial statement failed to disclose Von Eugen's role as a business broker. However, this too, would be insufficient to allege fraud because no facts were alleged from which an inference could be drawn that this alleged failure to disclose was fraudulent. In addition, the final amended complaint overlooked the following:

(a) Main Lafrentz' sole function in connection with 3I was to render an opinion with respect to 3I's financial statements. The financial statements, and the notes thereto, did not purport to set forth <u>all</u> the particulars of the transaction by which 3I acquired the data bank license.

(b) The final amended complaint did not allege any reason why 3I should have disclosed Von Eugen's identity. His only relevance to the transaction was that he received part of the consideration given by 3I in connection with the acquisition of the data bank license, and the amount of this consideration was fully revealed.

(c) 3I's letter agreement with Von Eugen (Ex. 2) was filed with the SEC (511a). Consequently, no intent to defraud by allegedly masking Von Eugen's identity can be inferred.

Paragraph 34(d) of the final amended complaint alleged that the 3I 1970 financial statement failed to disclose that the 3I assets had been "materially overstated and inflated as $1,000,000 by the inclusion of the data bank license stated at cost, whereas in fact defendants had deceptively utilized inflated restricted stock in their transaction." (501a) Aside from the conclusory allegation that defendants had acted "deceptively," and had used "inflated" restricted stock, it is difficult to tell what that allegation intended to charge. In any event, it is not necessary to repeat the full facts with respect to the valuation of the data bank license set forth above at pages 7 to 17. These show that the valuation was fully disclosed in the financial statements.

Paragraph 34(e) of the final amended complaint alleged that the financial statement failed to disclose that SLC had sustained a net earnings loss for the fiscal year and that "accordingly" there was no basis for 3I's opinion that SLC "would achieve the necessary earnings to support the amended agreement." (501a) No specific averment of fraud was made against Main Lafrentz; it was 3I, not Main Lafrentz, which that complaint apparently charged with

rendering an opinion regarding SLC's earnings which was allegedly without foundation. It is unclear what charge was made against Main Lafrentz; it appears that Main Lafrentz failed to disclose that SLC had a loss, but, even assuming this is so, there were no allegations concerning why it was allegedly fraudulent for Main Lafrentz to fail to do so. The summary judgment motion had set forth in detail why, assuming -- contrary to fact -- that there had been a loss under the SLC acquisition agreement, this minor loss need not have been disclosed. See pages 18 to 22 supra. The failure to make these critical allegations, then, must have been intentional.

In sum, the final amended complaint, to the extent one could understand its allegations, was totally devoid of merit. Main Lafrentz, in its motion, asked the Court to either dismiss it on its face, or grant summary judgment on its reckless charges.

By Order and Memorandum Decision filed March 29, 1974, the Court granted the motions to dismiss without leave to amend; Judge Bonsal stated that he did not reach Main Lafrentz' summary judgment motion (563a). This appeal followed.

ARGUMENT

THE THIRD AMENDED COMPLAINT DID NOT MEET THE REQUIREMENTS OF RULE 9(b) AND DISMISSAL WITHOUT LEAVE TO AMEND WAS WITHIN THE DISCRETION OF THE DISTRICT COURT.*

We have set forth above the generalized and conclusory allegations against Main Lafrentz contained in the last amended complaint, to which the appellants added general allegations of "conspiracy" and "aiding and abetting." Analysis shows beyond peradventure that the final amended complaint on its face was woefully inadequate, and purposefully so to attempt to avoid the Main Lafrentz summary judgment motion.

As noted above, Judge Bonsal specifically stated that he did not reach the Main Lafrentz summary judgment motion, but granted the motion under Rules 12(b)(6) and 9(b) of the Federal Rules. Thus, the Court did not address itself to the point by point refutation of the charges which Main Lafrentz had been compelled to assume were made in the final amended complaint. Instead, Judge Bonsal limited his decision to the face of the final amended complaint, and found it severely wanting under the applicable Rules and decisions in this Circuit. With respect to Main Lafrentz specifically, Judge Bonsal's decision pointed out

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* A more complete discussion of the law relating to Rule 9(b) is found in the brief submitted by appellees Marine Midland and Brownstein, upon which we rely, and will not be repeated here.

that "allegations of fraud made against accountants and others whose business depends on clients' trust and confidence" must be "set forth more completely than in an ordinary complaint" because the allegations of fraud "threaten their entire professional status." (561a)*

In pointing out the stringent requirement of particularity under Rule 9(b) in cases involving accountants and other professionals, Judge Bonsal was eminently correct. The main reason for requiring that allegations against accounting firms and other professionals be stated with special particularity relates to the importance of the reputation of the professional to his livelihood, and the abuse which would arise if general and unsubstantiated charges, such as those in this series of complaints, could be made with abandon.

Recognition of this harm to reputation and goodwill, which arises out of any allegation of fraud is found in this Court's leading decision of Segal v. Gordon, 467 F.2d 602

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* Appellants' argument that Judge Bonsal should have converted the motion to dismiss into a summary judgment motion because he accepted "matters outside the pleading" is patently frivolous. Appellants assume, contrary to Judge Bonsal's statement that he did not reach the summary judgment motion (562a) and the Decision itself, which is limited to the complaint, that he relied on matters outside the pleading. This is an assumption which, contrary to authority, would have this Court "impute error where the record does not require it." Duane v. Altenburg, 297 F.2d 515, 518 (7th Cir. 1962); See also United States v. Tutino, 269 F.2d 488, 491 (2d Cir. 1959); Moffett v. Commerce Trust Co., 187 F.2d 242, 249 (8th Cir.), cert. denied, 342 U.S. 818 (1951); Feinberg v. Leach, 243 F.2d 64, 68 (5th Cir. 1957).

(2d Cir. 1972). There this Court explained that the specificity requirement of Rule 9(b) relates to the harm to the reputation and goodwill which necessarily arises out of a fraud charge:

> "Rule 9(b)'s specificity requirement stems not only from the desire to minimize the number of strike suits, but also more particularly from the desire to protect defendants from the harm that comes to their reputations or to their goodwill when they are charged with serious wrongdoing:
>
> > 'It is a serious matter to charge a person with fraud and hence no one is permitted to do so unless he is in a position and is willing to put himself on record as to what the alleged fraud consists of specifically.'"
> > 467 F.2d at 607, quoting from 1A W. Barron & A. Holtzoff, Federal Practice & Procedure § 302 (Wright rev. 1960).

This concept was applied specifically to accountants and other professionals by Judge Lucas in his decision in Frazier v. Stellar Industries, Inc. (Civ. No. 72-2829-MML, C.D. Cal., November 15, 1973).*

There the court stated that professionals, such as lawyers and accountants, are entitled to the most specific averments when fraud is alleged:

> "The charge of fraud is a serious one, since it involves moral turpitude. Made against lawyers, accountants, or others whose business depends on clients' trust and confidence, a fraud charge threatens their entire professional status." (p. 16)

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* Copies of this unreported decision will be handed up to the Court at oral argument.

Thus, concluded Judge Lucas, allegations of fraud against such professionals must be most specific in nature. Citing this Court's decision in Segal v. Gordon, supra, Judge Lucas went on:

> "Words like 'conspiracy' 'participate', and 'aiding and abetting' do not supply this connection [between the defendant and the alleged fraud]. They only state the conclusion that such a link exists, without showing the basis for inferring it. They are inadequate in themselves as allegations." (p. 17)

Recently this same rationale was applied in Sloan v. Canadian Javelin Ltd., CCH Fed. Sec. L. Rep. ¶94,579 (S.D.N.Y. May 30, 1974). There the Court also discussed rationale behind Rule 9(b) as expressed in Segal v. Gordon, supra, and held that allegations of fraud against professionals must be extremely specific in nature:

> "Because allegations of fraud made against accountants and others whose business depends on clients' trust and confidence can threaten their entire professional status, Rule 9(b) requires that plaintiffs set forth more completely than in an ordinary complaint the factual circumstances that allegedly entitle them to relief." p. 96,033

See also S.E.C. v. Republic National Life Insurance Co., CCH Fed. Sec. L. Rep. ¶94,768 (S.D.N.Y. July 17, 1974).

Appellants have had more than ample opportunity to state their allegations against Main Lafrentz in compliance with the requirements of Rule 9(b). However,

they have persisted in ignoring the relevant facts and in submitting generalized and inadequate, and often incomprehensible allegations. Judge Bonsal properly exercised his discretion in finally calling a halt to this practice. See, e.g., Heart Disease Research Foundation v. General Motors Corp., 463 F.2d 98 (2d Cir. 1972). This litigation has been an inordinate burden upon the Court, and an unfair and unnecessary burden and expense for Main Lafrentz. In such circumstances the dismissal without leave to amend was clearly proper.*

CONCLUSION

For the reasons stated above, and in the brief submitted by Marine Midland and Brownstein, the judgment appealed from should be affirmed in all respects.

Respectfully Submitted,

Dated: September 25, 1974

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* Main Lafrentz does not believe the class action motion is before this Court because it was not decided by the court below. Judge Bonsal merely indicated that he "would deny" the motion had he not dismissed the final amended complaint (563a). In any event, as demonstrated in the brief of Marine Midland and Brownstein, denial of the class action motion in the circumstances of this case would clearly be proper.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ROBERT R. FELTON et ano.,

Plaintiffs-Appellants,

-against-

WALSTON AND CO, INC., et al.,

Defendant-Appellees.

No. 74-1581

AFFIDAVIT OF SERVICE

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

ROBERT THATCHER, being duly sworn, deposes and says that he is employed by the law firm of Kaye, Scholer, Fierman, Hays & Handler, is over the age of twenty-one years and not a party to this action.

1. On the 25th day of September, 1974, deponent served two true copies of Brief of Defendant-Appellee Main LaFrentz & Co., annexed hereto, by depositing same, enclosed in a sealed postpaid wrapper in the post office box regularly maintained by the U.S. Postal Service at 425 Park Avenue, New York, New York addressed to the attorneys on the attached list, these being the addresses designated by said attorneys for that purpose upon the preceding papers in this action.

Robert Thatcher
Robert Thatcher

Sworn to before me this
25th day of September, 1974

Notary Public

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Notary Public, State of New York
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